ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

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Related Bills:	See Legislative History	Telephone:	845-3410	Introduced Date:	02/22/2000
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SUBJECT: Scholarshare Trust Deduction/Franchise Tax Board Report to Legislature Annually Regarding Utilization of Deduction

SUMMARY

Under the Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (B&CTL), this bill would allow taxpayers a deduction equal to 50% (not to exceed $1,200 per year) of the amount of any contribution by a qualified taxpayer to a Scholarshare trust made on behalf of any qualified beneficiary.

EFFECTIVE DATE

This bill would be effective immediately upon enactment and apply to taxable and income years beginning on or after January 1, 2000, and before January 1, 2005.

LEGISLATIVE HISTORY

Federal P.L. 104-188 (1996), amended by P.L. 105-34 (1997), established an exemption from federal taxation and tax-deferred treatment for contributions to and earnings from qualified state tuition programs.

AB 530 (Stats. 1997, Ch. 851) established the California Golden State Scholarshare program, which, in conformity with the federal qualified state tuition criteria, provided an exemption from state taxation and tax deferred treatment for contributions to and earnings from the Scholarshare program.

AB 2797 (Stats. 1998, Ch 322) allows, by direct conformity to the federal provisions, an exemption from state taxation and tax deferred treatment for contributions to and earnings from any state's qualified state tuition program.

SB 1262 (Stats. 199, Ch. 664) made a number of technical changes to the California Golden State Scholarshare program under the Education Code, including making the Scholarshare Investment Board, which is chaired by the state Treasurer, responsible for administering the program instead of the Student Aid Commission.

PROGRAM HISTORY/BACKGROUND

Several states, including California, have adopted tuition prepayment programs that allow purchasers to pay in advance for educational costs of a designated beneficiary at a participating institution, usually an in-state public college. The programs pool all payments into one large fund and invest it with the goal of achieving a rate of return higher than the anticipated rate of tuition increases at participating colleges.

Board Position:			Department Director	Date
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When the beneficiary enrolls at a participating college, the program pays to the school the amount it charges at that time for tuition and fees and any other prepaid expenses, such as housing costs. In some states, purchasers sign contracts to pay for a certain type and amount of benefits, such as two years at a community college, two years at a community college plus two years at a state university, or four years at a state university. Other states allow purchasers to buy smaller units of benefits, such as college credit hours. The programs charge roughly current prices for tuition and fees and other prepaid benefits. In some cases, a premium may be charged; in others, a discount may be offered. Purchasers typically can choose between either one lump-sum payment or a long-term payment plan. Various refund provisions apply if the beneficiary cannot use the benefits due to death or disability, chooses not to go to college, or decides to attend a nonparticipating college. Under certain circumstances, a specified rate of interest may be paid on the refunded amount.

SPECIFIC FINDINGS

Existing federal and state laws provide that gross income includes all income from whatever source derived, including compensation, gross business income, gains from property, dividends, rents, interest, and royalties. In the case of interest, all interest received or credited to a taxpayer's account (accrued) is included in gross income unless it is specifically exempt.

Existing state and federal laws allow certain expenses to be deducted when determining tax liability. For individuals, some expenses may be deducted when calculating adjusted gross income (AGI), such as penalties forfeited to a bank or other type of financial institution because of early withdrawal of funds from a time savings account, certificate of deposit, or similar classes of deposit. Other expenses, such as charitable contributions, interest, and taxes, are deducted when calculating taxable income. Expenses for the production of income and certain employee business expenses are considered miscellaneous itemized deductions and must exceed 2% of AGI to be deducted. For businesses, expenses that are considered ordinary and necessary for the operation of that business are generally deductible unless otherwise specified.

Existing federal law (IRC 529) provides that a state tuition program is qualified and exempt from federal taxation if it meets the following criteria:

A. Established and maintained by a state agency or instrumentality;
B. Purchases or contributions may be made only in cash;
C. More than a de minimis penalty is imposed on any refund of earnings from the account that are not:
    1. used for qualified higher education expenses of the designated beneficiary;
    2. made on account of the death or disability of the designated beneficiary; or
    3. made on account of a scholarship received by the designated beneficiary to the extent the refund does not exceed the amount of the scholarship used for qualified higher education expenses;
D. Provides separate accounting for each designated beneficiary;
E. Provides that contributors and beneficiaries may not, directly or indirectly, direct the investment of any contribution to the program or earnings thereon;
F. Does not allow interest in the program to be used as security for a loan;

G. Prohibits contributions in excess of that necessary to provide for the qualified higher education expenses of the beneficiary, which are defined as tuition, fees, books, supplies, and equipment and reasonable costs for room and board; and
H. Provides for program reporting to the Internal Revenue Service (IRS) of distributions and educational benefits received.

This **federal law** provides that the gross income of the contributor does not include earnings (at the time they are earned) under the program and that the gross income of the beneficiary does not include contributions to or earnings (at the time they are earned) under the program. However, distributions from the program in excess of amounts contributed (such as interest or dividend earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made. The furnishing of education to a designated beneficiary is considered a distribution. The California Golden State Scholarshare program (discussed below) meets the criteria listed above; therefore participants in the state Scholarshare program receive these federal tax benefits.

Existing federal law provides two other types of education-related tax incentives. The Hope credit program allows qualified taxpayers a nonrefundable credit of 100% for the first $1,000 of qualified tuition and related expenses and a 50% credit for the next $1,000 of qualifying expenses, for a total credit of $1,500 each year per student. Beginning in 2001, the credit is indexed for inflation. The tax credit is phased out for single taxpayers with a modified adjusted gross income of between $40,000 and $50,000 and for joint filers with adjusted gross income of between $80,000 and $100,000. The Hope credit may be claimed for an eligible student for only two taxable years. The Lifetime Learning credit program allows taxpayers a nonrefundable 20% credit for up to $5,000 per taxpayer in qualified tuition and related expenses for graduate and undergraduate courses at an eligible education institution. The phase-out provisions for this credit are the same as those for the Hope credit. There is no limit to the number of years that a Lifetime Learning credit may be claimed.

Existing federal law also provides that taxpayers may contribute up to $500 per beneficiary (until the beneficiary reaches the age of 18) to an education individual retirement account (IRA), a tax-favored trust, or custodial account created to pay the costs of a beneficiary's higher education. Contributions are not deductible, but withdrawals to pay the cost of a beneficiary's postsecondary school tuition and room and board are exempt from tax. The amount that a taxpayer is permitted to contribute to an education IRA is phased out for single taxpayers with a modified adjusted gross income of between $95,000 and $110,000 and for joint filers with adjusted gross income of between $150,000 and $160,000.

For regular IRAs, **existing federal law** provides that the 10% early withdrawal penalty does not apply to distributions used to pay the qualified higher education expenses (including those related to graduate–level courses). This program does not provide a phase-out limitation.

In each year, taxpayers may elect with respect to an eligible student to take either the Hope credit, the Lifetime Learning credit, or tax-exempt distributions from an education IRA. This election limitation does not apply to qualified distributions from a prepaid tuition program.

The existing state Education Code established the Golden State Scholarshare Trust. The Scholarshare Investment Board may enter into participation agreements with participants for the advance payment of qualified higher education expenses for a beneficiary to attend an institution of higher education. The participation agreement provides the terms and conditions for payments made to the trust and the minimum rate of interest borne by the investment in the trust. The program establishes an overall maximum investment level for a designated beneficiary of the amount equivalent to the maximum estimated qualified higher education expenses, as defined, that can be incurred by a beneficiary to obtain a baccalaureate degree at an institution of higher education in California for four years. A more than de minimis penalty is imposed if a participation agreement is canceled for reasons other than death or disability of the beneficiary or in the event the beneficiary receives a scholarship. Pursuant to the participation agreement, the commission invests the pooled trust moneys and any earnings therefrom inuring to the state are used to make payments to institutions of higher education on behalf of beneficiaries and to pay for administration costs. The Scholarshare Investment Board is required to adopt regulations to implement the Scholarshare program that are consistent with the requirements for exclusion or deferral from federal taxation.

The trust is required to provide an annual listing to the department of all Scholarshare distributions.

Existing state Revenue and Taxation Code provides an exclusion from gross income for contributions and tax-deferred treatment for earnings on contributions to the California Golden State Scholarshare program, which approximates the federal law, by: (1) exempting from taxation to the participant or beneficiary earnings from the trust at the time they are earned; (2) providing that distributions from the program in excess of amounts contributed (such as interest earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made; and (3) providing that the furnishing of education to a designated beneficiary is considered a distribution. Taxpayers who withdraw their funds early from a Scholarshare account (cancel their participation agreement) and incur a penalty would not be allowed the deduction for early withdrawal of savings.

Existing state Revenue and Taxation Code, through direct conformity to the federal qualified state tuition program, provides the same tax exclusion and tax deferred treatment to California taxpayers who participate in any state’s qualified state tuition program.

Neither federal nor state law currently allows a deduction for contributions to the state Scholarshare program or other qualified state tuition programs.

This bill would allow taxpayers a deduction equal to 50% (not to exceed $1,200 per taxable year) of the amount of any contribution by a qualified taxpayer to a Scholarshare trust made on behalf of any qualified beneficiary.

“Qualified beneficiary” would include only those individuals for whom a Scholarshare account has been established and who are eligible to be claimed as a dependent on the taxpayer’s return.

A “qualified taxpayer” would mean individuals whose federal adjusted gross income is between $40,000 and $50,000 ($80,000 and $100,000 for joint filers).

The deduction would not be allowed for any expenses for which a credit also is allowed. If withdrawals do not constitute qualified higher education expenses, as defined, this bill would impose a 10% penalty.

Since **this bill** does not specify otherwise, this deduction would be considered a miscellaneous itemized deduction and allowed only to the extent that it exceeds 2% of the taxpayer's AGI.

This bill would require the Scholarshare Investment Board to report to the department the amount of annual contributions and the point in time at which the contributions have reached the maximum level. The bill would require the department to report, to the extent data is available, on the utilization of the deduction allowed under the bill.

Policy Considerations

This bill, as written would allow the deduction only to taxpayers whose federal adjusted gross income is between $40,000 and $50,000 (single) and $80,000 and $100,000 (joint). After discussions with the author's staff, the department understands that this provision was intended to create a phase out for the deduction. The bill is intended to allow the deduction to those taxpayers whose income is less than $50,000/$100,000 (single/joint and head of household) and to be phased out for incomes between $40,000 and $50,000 (single) and $80,000 and $100,000 (joint).

The Scholarshare program allows any taxpayer, such as parents, grandparents, friends, or corporate donors, to make contributions on behalf of a specified beneficiary. However, this bill's language would allow the deduction only to taxpayers who can claim a beneficiary as a dependent on their own return. Thus, the deduction would provide unequal tax treatment to contributors who can claim beneficiaries as dependents and those contributors who cannot.

Implementation Considerations

Department staff has identified the following implementation considerations. These implementation considerations would make it difficult to properly implement this bill. Additional concerns may be raised as the department continues to analyze the bill. Department staff is working with the author's staff to assist with any necessary amendments to resolve these concerns.

1. This bill states that the deduction would be allowed for contributions made by a qualified taxpayer, but does not clearly specify that only the qualified taxpayer who makes the contribution would be allowed the deduction. As the bill is written, some other taxpayer could claim the deduction.

2. This bill would require that a "qualified beneficiary" be an individual who is eligible to be claimed as a dependent on the "taxpayer's" return. This criterion leaves unclear whether the qualified beneficiary must be a dependent of the qualified taxpayer who made the contribution or any taxpayer claiming the deduction.

3. The B&CTL provisions in this bill appear to improperly use language intended solely for the PITL. For instance, corporate taxpayers are not "individuals;" nor do corporations have dependents or adjusted gross income.

4. The provision that would deny the deduction when a credit is allowed for the same expenses could cause confusion. The deduction under this bill would be for contributions made to the Scholarshare trust. These contributions are not properly characterized as expenses. In addition, deductions authorized by this bill for contributions to a Scholarshare trust account would occur several years before amounts in an account are used to pay educational expenses that might qualify for a credit under existing law. A retroactively effective disqualification is difficult to implement.

   Department staff understands from discussions with the author's staff that the intent is to prevent taxpayers from getting a deduction for contributions that eventually will be used to pay education expenses and getting any state tax credit (like the federal Hope credit, if one is enacted) for those same education expenses. It might be better, and would be easier for the department to implement, if any credit that is enacted in the future for the same expenses includes a provision to reduce that credit by the amount of the deduction allowed for amounts deducted under the bill.

5. The provision regarding the 10% penalty also could cause confusion. It is unclear how a withdrawal would "constitute qualified higher education expenses." Department staff understands from discussions with the author's staff that the intent is to provide a penalty, in addition to that provided in the existing Education Code, for those cases in which the Scholarshare participation agreement is canceled prior to payment of higher education expenses for the beneficiary and the taxpayer already received a deduction under this bill. A penalty for withdrawals from a Scholarshare trust account would be better placed with provisions related to the Scholarshare trust account rather than with provisions related to deductions for contributions to a Scholarshare trust account.

6. The provisions that would require the department to make a report do not specify to whom the report would be made. Further, although the bill states that the report is to be made "to the extent data is available," currently the department does not capture individual deductions from tax returns. Therefore, the data would not be available to report.

Technical Considerations

Department staff has identified the following technical considerations. Additional concerns may be raised as the department continues to analyze the bill. The department is working with the author's staff to resolve these concerns.

1. The reference to the definition of "Scholarshare trust" should be subdivision (f) instead of subdivision (i) of Section 69980 of the Education Code.

2. The term “taxable year” in the B&CTL provision should be changed to “income year” wherever it appears.

3. For consistency with the other Scholarshare provisions in the PITL and B&CTL, the term “participant” should be used instead of “qualified taxpayer” and “taxpayer.”

4. The word “federal” before adjusted gross income is unnecessary and can be removed, since state law already applies limits based on “adjusted gross income” by reference to federal "adjusted gross income."

LEGISLATIVELY MANDATED REPORTS

This bill would require the department to report, to the extent data are available, on the utilization of the deduction allowed under the bill.

FISCAL IMPACT

Departmental Costs

If the implementation considerations addressed in this analysis are resolved, the department’s costs are expected to be minor.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses under the PITL.

Estimated Revenue Impact of AB 2095 As Introduced Assumed enactment after June 30 [$ In Millions]		
2000-01	2001-02	2002-03
-$1	-$3	-$4

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The amount of deductible contributions and the average marginal tax rate of qualified taxpayers would determine the revenue impact of this bill. Estimating the amount of deductible contributions required projecting the following:

1. The total number of qualified beneficiaries each year (20,000 in the first year growing to 100,000 by year-end 2004);

2. An average contribution for each qualified beneficiary ($2,400) multiplied by the proposed deduction percentage of 50% (the maximum deduction is limited at $1,200); and

3. The number of qualified taxpayers each year who would have deductible contributions (1,700 in the first year growing to 8,400 by year-end 2004); and

The liability year revenue loss was derived by applying an average marginal tax rate of 6% to the amount of deductible contributions. Liability year estimates were converted to cash-flow estimates above. Cash-flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

Although the deduction is proposed under the PIT and B&CT laws, by definition of a qualified taxpayer, it could be applicable only to individuals, as no corporation would have a qualified beneficiary that could be claimed as a dependent.

Existing language defines a qualified taxpayer as an individual whose federal adjusted gross income is between $40,000 and $50,000 (single) and $80,000 and $100,000 (joint). Based on discussions with the author's staff, it is assumed that a qualified taxpayer was intended to be an individual whose income is less than $50,000/$100,000 (single/joint and head of household) and the proposed deduction would be phased out for incomes between $40,000 and $50,000 (single) and $80,000 and $100,000 (joint). Therefore, if an individual's income exceeds $50,000/$100,000 (single/joint), a deduction would not be allowed.

The launch date for the Golden State Scholarshare program was October 4, 1999. As of February 9, 2000, contributions totaled $29.7 million for the benefit of 5,858 beneficiaries. Dividing the $29.7 million by 5,858 beneficiaries indicates a simple average contribution of $5,070 per beneficiary.

The number of qualified beneficiaries was estimated at 20,000 by year-end 2000 by annualizing the number of current beneficiaries in the Scholarshare program with growth assumed. Since the calculated simple average contribution exceeded the contribution necessary to get the maximum deduction of $1,200 under the proposal, an average contribution of $2,400 was used.

To derive the number of qualified taxpayers each year, the following adjustments were made to the estimated number of qualified beneficiaries. First, the number of qualified beneficiaries was reduced to represent the approximate number of households (i.e., some taxpayers would establish an account for more than one beneficiary). Second, based on tax return data, the number of households was reduced to reflect the number of taxpayers with federal adjusted gross income of $50,000/$100,000 or less. Third, the remaining number of taxpayers was further reduced to eliminate those taxpayers who would not itemize their deductions or, if they itemized, would not have sufficient miscellaneous itemized deductions (with the proposed deduction in place) to exceed the 2% of AGI threshold. The number of qualified taxpayers who would have deductible Scholarshare contributions under this proposal is estimated at 1,700 in 2000 and would grow incrementally each year to 8,400 by year-end 2004.

BOARD POSITION

Pending.